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Yuan Action Creates Fresh China Conundrum for U.S. Treasury

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China's surprise devaluation of the yuan may make it harder for the Obama administration to balance its praise-and-prod strategy toward the world's second-biggest economy.

About 16 hours after China cut the yuan's value against the dollar by 1.9 percent, the U.S. Treasury issued a statement tiptoeing around the issue, saying it's too early to judge the implications of China's move. The People's Bank of China called the change a one-time adjustment and said the currency's fixing will become more aligned with supply and demand; Whitney Smith, a Treasury spokeswoman in Washington, said that "any reversal in reforms would be a troubling development."

Treasury Secretary Jacob J. Lew in recent months has credited China for making its currency more flexible and reducing intervention over the past year. At the same time, the department has maintained that the yuan remains undervalued and urged China to make the exchange rate more market-determined and transparent to sustain expansion.

"This move creates a conundrum for the U.S. administration," said Eswar Prasad, a professor of trade policy at Cornell University and former head of the financial studies and China divisions at the IMF. "China has given the U.S. and the international community exactly what they were asking for, which is a more market-determined exchange rate, but the Chinese have done this on their own terms and at the time that is convenient to them and not necessarily for the rest of the world economy."

The devaluation renewed congressional complaints that China's currency policy gives it an unfair advantage over U.S. companies. While embracing currency market forces may help China's case to join the International Monetary Fund's ranks of global reserve currencies in a decision due in late 2015, the nation's action is spurring political pressure on an already-reluctant U.S. administration to reject such a move.

Schumer Comment

Senator Charles Schumer, a New York Democrat who has been one of the harshest critics of China's currency policy, said Tuesday that China's latest action suggests the nation is "doubling down" on manipulating the yuan. The yuan "should be barred from consideration as a global reserve currency by the IMF" unless China "stops artificially devaluing" it, Schumer said in a statement.

Lew clashed with Schumer at a February congressional hearing. "We have not been very successful against China," the senator said at the time. Lew countered that "we have pushed hard to have China stop intervening in ways that they had been" and highlighted appreciation in the yuan since 2010.

Senator Rob Portman, an Ohio Republican, said the devaluation "is another harsh reminder that we cannot afford to sit idly by as China refuses to play by the rules." Michigan Representative Sander Levin, the top Democrat on the House Ways and Means Committee, which has jurisdiction on currency matters, said it's important to note that China "is increasingly intervening in its stock market and other markets."

"It's going to be a rough couple of weeks for Secretary Lew," said Adam Posen, president of the Peterson Institute for International Economics in Washington and a former Bank of England policy maker. While Posen said he supported the Treasury's recognition of yuan appreciation, "unfortunately, the Congress doesn't tend to make fine distinctions between one-time and sustained interventions, or between adjustments towards a fair rate versus adjustments away."

State Visit

The move comes as both sides try to ease tensions before U.S. President Barack Obama hosts China President Xi Jinping for a state visit in September. In June's Strategic and Economic Dialogue, the annual high-level meeting of officials from both countries, Lew reiterated that China needs to let market forces have a bigger role determining the yuan's exchange rate.

Treasury's Smith said Tuesday that the department will keep monitoring how China implements its changes and keep pressing China on the pace of its reforms.

"It does put the U.S. Treasury in an awkward position, because they are moving to a more market-determined rate," said David Dollar, a senior fellow at the Brookings Institution in Washington, who previously worked for the U.S. Treasury in Beijing. "But the pressure in that market in the short run might be for the currency to devalue."